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COMMENT: PREPPING THE ELEPHANT

Robert P. Reffner[†]

A little bit about me: I graduated from Case Western Reserve University School of Law twenty-three years ago. I am in the business of joint ventures, venture capital, and merger acquisitions. My first exposure to the venture capital business was representing Lubrizol Enterprises, a venture capital entity of the Lubrizol Corporation. My firm served as counsel in cutting edge venture capital transactions in the mid-1980s. Some transactions were pretty nifty, such as injecting toxic genes into plant genomes to make them inherently resistant to insects. Interestingly enough, on the other side of that deal was a lawyer by the name of Harry Plant.

My firm has participated in this economy. We closed about sixty transactions in the last three years or so, in excess of four billion dollars. Those have been classic venture capital deals—joint venture transactions, roll-ups, public financings, and some with international components.

In fifteen minutes I could not possibly talk about all you need to know about private equity and its future, so I will talk about things of personal interest within the world of private equity. I will share some ideas on the market data, talk about venture funds and the skill sets lawyers bring to the table, and discuss lawyers taking equity in transactions, applicable ethical issues, and—because I am a lawyer—examine the current state of the law.

You may ask the question: Are lawyers relevant to this? There is a lot of talk today about relevance. Do lawyers find the title of “lawyer” to be elevating? I think the business community sees it as isolating. There are a lot of business consultants. Are we consultants or lawyers?

I think that good lawyers are in the business of business consulting, so are we relevant? We have come up through the boardroom. We now participate in business model due diligence as well as

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legal due diligence. The data say some venture capital firms are receiving 2000 proposals per year. Venture capital data show investments of \$200 million a day with companies spending an average of \$17 million per deal. There is a need for speed, effectiveness, and value.

Such an environment is no place for on-the-job training. Lawyers can get into trouble in a hurry. A search of the Internet turned up a Private Investment Fund Forum, an association of law firms representing the venture capital industry.¹ This association claims to possess expertise in venture funds.

The scope of advice and the pace has picked up. How has that impacted lawyers? How are lawyers relevant?

I believe that lawyers are navigators, especially when they represent the target. You are in the business of taking somebody from St. Louis to California. You have done it before. You are a guide. They are counting on you to navigate a lot of different things.

They are counting on you to navigate the law. Lawyers understand this. Regulatory issues, structural issues, the whole range of things presented to your client for the first time are things that are familiar to you, and that is what they are counting on you to do.

There is a good article somebody once sent to me that said, "Can the practice of law be fun?" If you turned to the next page, it said, "No!" When you are representing either the seller or the investing company, you confront people in great stress who have never done this before. It is a lifetime decision that makes them behave in unusual and aberrant ways. After the deal closes, the participants return to their normal behavior, and you move on to the next person in a stressful condition. I have always thought this true.

There is a lot of talk in northeastern Ohio about technology, and technology forums have had a great deal of play in the *Cleveland Plain Dealer* in recent weeks. If you look at the data—and the data bounces around a little bit—ninety-five, ninety percent of the deals are in the technology sector. The Midwest ranked fourth of the various geographic centers for investment, representing about five percent of the total invested deals.

As an industrial company lawyer, it was interesting for me to see that "industrial manufacturing" ranked thirteenth. Healthcare was a little higher. In northeastern Ohio and the Midwest, we still see ourselves as making and shipping things.

I want to take a second to talk about corporate venture funds. Corporate venture funds represent about twenty percent of the third

¹ See *Lawyers' Group Tackles Legal Questions* (visited Feb. 9, 2001) <<http://www.assetnews.com/ped/attorneys/intro.htm>>.

quarter results or about \$12 billion of investment.² Often, when you represent a corporate venture fund in a venture capital deal, the venture funds are doing the “laboring-oar” work on the investment terms. The corporate players in venture deals tend to have special terms. They are taking first looks at the technology and making ancillary arrangements and research collaborations. Corporate venture funds face some interesting conflicts. If your corporate player is taking an equity position, what is its right to act independently? What is its right to vote solely in its independent business interest as it sits on the board of directors? You need to consider that on the front end of the transaction.

There is enormous activity occurring in the private equity field. *The Wall Street Journal* reported that Royal Dutch Shell has formed Shell Internet Investors and has partnered with joint venture firms in the United States and Asia to develop their Internet interests.³ Is all this change in activity an opportunity for us? How are we relevant to the marketplace?

David Maister in *True Professionalism* says that if you only work on what you know how to do, “you’ll eventually be overtaken by someone younger.”⁴ I think there is a lot of truth to that. I think lawyers are still relevant, and I see their importance only improving.

For instance, consider the conversation we have had this morning about due diligence. Take a venture enterprise with eighty companies in its portfolio. There is an enormous amount of activity that goes on in that portfolio on a daily basis, much of it strategic. Much of it involves relationships or potential conflicts among people, and where there are conflicts among people, lawyers are needed.

Lawyers are experts at assessing people. Whether you represent a sophisticated corporate investor, a venture fund, or an angel, you are always assessing people. Are they real? There is a smell test that lawyers develop to know whether something is real—a very important sense to bring to this process.

The accountants’ claim to fame is that they know the chief financial officer, and the chief financial officer makes the “buy” decisions and consulting decisions. I think lawyers come to it with a different touch point. Lawyers are comfortable with conflict. (As we know right now from the electoral scene, there is a lot of conflict to be contended with.) Business lawyers bring to the process the ability to resolve conflict and still preserve the relationship. That is a unique effort. Litigators like to think that they are the only ones who deal

² See Alistair Christopher, *Corporate Venture Capital: Moving to the Head of the Class*, VENTURE CAP. J., Nov. 2000, at 43.

³ See Suzanne McGee, *Shell Starts ‘New Economy’ Fund*, WALL ST. J., Nov. 9, 2000, at C22.

⁴ DAVID H. MAISTER, TRUE PROFESSIONALISM 39 (1997).

with conflict. But when litigators go crazy, the judge serves as the midwife of truth. When corporate lawyers go crazy, they find themselves at an empty table. You have to be able to present difficult concepts and still be able to bridge relationships.

The skill sets have changed for transactions. Anybody who has done a large transaction realizes e-mail has its shortcomings. You get a team of ten, fifteen, twenty people working on something. You send an e-mail to fifteen people. If a recipient does not hit "reply to all," then a large part of the team is in the dark. If the chief financial officer comes in towards the end of the deal or some expert is consulted on some part of it, you get a call asking about the current status of some limited part of the deal. Reconstructing e-mail histories can be obscene. One solution is to use a virtual workroom where you post current data and other matters. Rather than circulate the information through e-mails, post it to the workroom. People come in, learn what they want, and move on. Virtual meetings, team collaboration using the Internet, real-time online—these are new skills critical for pursuit of the lawyer's trade. The stakes and pace are so high that you need these skills to keep up and to serve your clients. If you do not have them, you will be left behind.

That brings me to personal performance. Electronic resources have given us the ability to generate documents with tremendous complexity, but sooner or later somebody has to sit down and think about the problem, the transaction, and the broader scope. It is incumbent on lawyers to stop and think for the very reason that the world has become so fast-paced. You must stop and think about the deal. You must allow the brain-pan to catch up.

If you get an e-mail—it used to be "if you receive a fax," but now we have e-mail without a preceding phone call—people now call within minutes and ask for the answer. It is incumbent upon the professionals to ensure that the team has thought about the important things. We must find the stated strategic theme in the transaction and see how it has been woven into the deal. I do not apologize for saying, "Wait a minute. I need to sleep on it." In the end, when deals unravel, and the parties look at the legal documents, no one is going to remember how much time you did not have, and no one is going to care. You are responsible for protecting your professional reputation.

Finally, I would like to say a few words on lawyers taking equity in deals. Lawyers who receive equity in transactions they handle have received a lot of publicity in the legal press.⁵ One firm's holdings were worth \$51 million at close of opening day. That was the

⁵ See e.g., Debra Baker, *Go West, Young Lawyer*, A.B.A. J., May 2000, at 34 (detailing the rise of West Coast law firms and the threat they pose to historic New York City law firms).

opening day—the stock closed at \$25 a share—but it is now worth about fifty cents a share.

Model Rule 1.8, which governs conflicts of interest, asks whether the compensation is fair and reasonable.⁶ An equity investment may impact the lawyer's ability to be disinterested. Thus, legal conflicts are exacerbated.

Many firms limit the amount of the investment to one percent or less of the issuer's stock. Some firms prohibit individual lawyers from investing. Typically, firms prohibit taking stock in lieu of fees. Finally, in many cases, if a lawyer invests, the firm requires the lawyer to abstain from work on the matter and to forego billing credit. Those of us in the business of getting paid by the partnership know that billing credit is important at compensation time. There are some major IPO firms that have taken the position "no investing allowed."

Finally, the law adapts, even to the new economy. As new business models emerge, the law responds by permitting and enabling the best in these models while at the same time protecting and clarifying the underlying principles in play. This is exhibited in Regulation FD,⁷ a new rule promulgated by the SEC providing fair disclosure requirements. It can also be seen in the antitrust releases applicable to business-to-business collaborations. Securities rules applicable to Internet securities offerings also show the response of the law.

I have a final thought on closings. We call closings "pulling the elephant through the keyhole and getting the elephant to enjoy the ride." The hardest part is prepping the elephant.

⁶ MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.8 (1999) (requiring fair and reasonable terms for the client, all of which must be disclosed, a reasonable opportunity for the client to receive advice of independent counsel, and client consent).

⁷ Selective Disclosure and Insider Trading, 17 C.F.R. §§ 243.100-103 (2000).

